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On Economic Transformation in East-Central Europe

A Historical and International Perspective

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The seemingly irreversible socialist experiment in East-Central Europe came to a sudden, largely unexpected, end in the late 1980s. That collapse generated important economic and political consequences. A broad historical and international perspective is needed to understand the ongoing transformation in the region.

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This paper — a product of the Macroeconomic Adjustment and Growth Division, Country Economics Department — is part of a larger effort in PRE to analyze the transition from central planning to a market economy in Eastern-Central Europe. Copies are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Emily Khine room N11-067, extension 39361 (38 pages, with tables).

The paper considers two periods: before socialism and after it. The former includes the 1920s, 1930s, and 1940s, and the second includes the late 1980s and early 1990s. The focus is on issues of economic reconstruction, hyperinflation, integration with the global monetary system and the functioning of the gold exchange standard, the impact of the great depression of the 1930s and its aftermath, and postwar monetary reforms. The study also compares per capita income and the structure of foreign trade of East-Central Europe with those of Western Europe and Latin America in the late 1930s and late 1980s.

Differences in per-capita income between Eastern and Western Europe widened after socialism. In 1937, before World War II and socialism, per capita income in Great Britain — then the highest in Western Europe — was 2.6 times per capita income in Czechoslovakia — then the highest in East-Central Europe. In 1988, the ratio of per capita income in West Germany — now with higher per capita income than Great Britain — to that of Czechoslovakia was 5.6. The average income per capita of Eastern Europe has moved closer to that of such Latin American countries as Argentina, Brazil, and Mexico.

Economic transformation in East-Central Europe probably will be a long and complicated process because the initial conditions for the transition to a market economy are very weak. In fact, the chief characteristics of these economies are macroeconomic imbalances, obsolete and uncompetitive productive capacities, a lack of modern infrastructure, underdeveloped factor markets, and weak institutions.

Nor is the external environment supportive. The disintegration of Comecon will entail large terms of trade losses for Eastern Europe vis-a-vis the Soviet Union. A massive influx of western capital is unlikely in the short to medium run. International capital markets will be reluctant to commit large amounts of credit to the region until reform is more consolidated.

On the political side, the initial euphoria over the end of the old regime is waning and people are less enthusiastic about reform because of the hardships accompanying the transition. Fragile and changing political coalitions and the signs of some surrender to the temptations of populism clearly reflect that tendency.

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1. Introduction

Current events in Eastern Europe are so far reaching in scope that a loo' at the economic (and political) history of the region seems as almost urgent, if the current changes are to be understood in full perspective. Extreme macroeconomic instability, economic reconstruction and structural transformation, the integration to a global monetary system, the domestic consequences of changes in international conditions are all phenomena already experimented in East-Central Europe before socialism was established after second world war. Thus, the study of the pre-socialist period of Eastern Europe may give valuable clues on the currents problems of transition to a market (or capitalist) system. A transition that constitutes, in a sense, a rendez-vous of the region with its own history (including also its problems).

The paper is organized as follows. Section 2 is on the 1920s and 30s. It documents the formation of the national states of what is today (subject to some territorial changes originated after the second world war) East-Central Europe. Then we discuss problems of macroeconomic stabilization and issues of economic recovery, the integration to the gold exchange standard and the tendencies towards protectionism developed in the second half of the 1920s. Then we turn to the 1930s examining the impact of the great depression, the collapse of the gold exchange standard, and the policy response of most East-Central European economies to those events. The effect of German rearmament on the economies of East-Central Europe in the second half of the 1930s is discussed. Further, we look at the levels of per-capita income and the main features of the economic structure of the region in the late 1930s. Section 3 is on the late 1940s. It analyses the establishment of socialism in the second half of the 1940s in East-Central Europe, including the policies of nationalization and the creation of central planning that laid the basis for running the economy at (soviet-style) socialist lines. From a macroeconomic perspective we devote attention to the implementation of monetary reforms in the 1940s and discuss the origin and stabilization of the Hungarian Hyperinflation of 1945-1946.

Section 3 jumps through history the late 1980s and early 1990s, with the collapse of socialism throughout East-Central Europe. There we state some of the initial conditions in the transition to the market economy and provide some historical and international comparisons of per capita income of the region. Finally, Section 4 of the paper offers concluding observations.

2. Economic History of East-Central Europe before Socialism: the Interwar Period

The end of the World War I led to the collapse of the four main monarchies that dominated East-Central Europe: the German, the Habsburg, the Ottoman and Czarist empires. Three independent states were born from the former Austro-Hungarian Monarchy: Austria, Czechoslovakia and Hungary. The latter was the most affected as it lost near two thirds of the territory of the former Hungarian Kingdom. Moreover, the kingdoms of Serbian and Croatan were turned into Yugoslavia. Reborn Poland (the new Polish Kingdom) received territories from the Austro-Hungarian monarchy, Germany and Russia. Some minor territorial changes took also place in Bulgaria, and the Kingdom of Rumania annexed territories from Hungary and Russia[1]. As those countries suffered a sizeable destruction of physical capital, infrastructure and losses in human capital during the war of 1914-1918, a first priority afterwards become economic reconstruction. At individual country level, Poland was the most hardly hit by the war and Czechoslovakia the one in a relatively better position after the conflict.

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[1] See Berend and Ranki (1974) for a full analysis of the economic history of East-Central Europe before (and after) world war I.

Table 1. East- Central Europe Before and After World War 1

	Area (in square Kms)		Population (millions)	
	1914	1921	1914	1921
Austro-Hungarian Monarchy	676,433		51,390	
Austria		85,533		6,536
Hungary		92,607		7,600
Czechoslovakia		140,394		13,613
Bulgaria	111,800	103,146	4,753	4,910
Rumania	137,903	304,244	7.516	17,594
Serbia	87,300		4,548	
Yugoslavia		248,987		12,017
Poland		388,279		27,184

Source: Berend and Ranki (1974)

2.1 The 1920s

An important economic consequence of the war was the total disorganization of public finances and the financial systems in most he region. That rapidly led to extreme macroeconomic instability and hyperinflation notably in Austria, Poland and Hungary. The making of the macroeconomic imbalances and high inflation of the early 1920s was connected to the financing of the war and its aftermath. Besides taxation and debt issuing the financing of world war I was done, to a great extent, by printing money. The impact of money creation on prices was (temporarily) cut because the use of extensive price controls and rationing of consumption goods (military needs had the priority in the allocation of resources). Thus, by the end of the war the population had accumulated large involuntary savings in the form of liquid assets. The accumulated money overhang certainly contributed to the outbreak of inflation. Moreover public finances came under strain as economic reconstruction demanded increased government spending and fiscal revenues were scarce, mainly in countries that lost assets at the outset of the conflict.

Macroeconomic instability was compounded by socio-political turbulence. A succession of short-lived, ideologically-diverse governments ruled during 1918-1919 in the several countries of the region. An example of that was the establishing of a soviet republic, lead by Bela Kun, in Hungary in March of 1919. In turn, the socialist experiment was followed by a right-wing government. The emergence of distributive conflict was also evident as workers sought a recovery of real wages, which were very depressed during the war. However, the external conditions left small room for accommodating such demands for higher real wages at home, because the reparations payments and the ensuing external transfer required an undervalued real exchange rate.

The war reparations payments sanctioned in the treaties of Versailles, St. Germain, and Trianon, adversely affected the countries born from the Austro-Hungarian monarchy and also Bulgaria, placing a severe burden on their public finances (table 2) and balance of payments. As a result of the war reparation payments and large fiscal deficits financed by printing money extreme inflation and massive exchange rate depreciation developed in Austria, Hungary and Poland (See Table 3.)[2]

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[2] The case of Germany's hyperinflation will not be discussed in this appear. For references in the literature see Graham (1930), Bresciani-Turroni (1937), Dornbusch (1987), Sargent (1982), Solimano (1990a), Webb (1989).

Table 2: Fiscal Budgets and Its Financing After World War I

Hungary	Percentage of Expenditures covered by Issues of Paper Money
1920-21	47.9
1921-22	24.1
1922-23	21.0
1923-24	34.4
Austria	
1 Jan. - 30 June 1919	67.0
1 July 1919 - 30 June 1920	63.0
1 July 1920 - 30 June 1921	58.0
1 Jan. - 31 December 1922	40.0

Source: Sargent (1982).

Table 3: Inflation in East-Central Europe in the 1920s

	Austria (Price Index, January 1921=100)	Hungary (Price Index, July 1921=100)	Poland (Price Index, January 1921=100)	Czechoslovakia (Price index January 1922 = 100)
1921 December	942	196.4	226.9	
1922 December	17,409	795.2	1,377.7	59.6
1923 December	21,849	17,000.0	566,055.5	58.8
1924 March	23,336	49,445.24	975,686.8	60.9
April	23,361	50,823.81	963,927.7	60.2
June	24,267	52,566.6		
September		53,252.3		

Source: constructed on the basis of Sargent (1982).

Hyperinflation in Austria, Hungary, and Poland in the early 1920s shared some common features: complete demonetization and shifts of the portfolios of domestic residents toward foreign currency and gold, dramatic increases in the fiscal deficits (partly endogenously generated by the reduction in real tax collection induced by inflation), very rapid depreciation of the exchange rate and the complete destruction of the pre-existing contract- structure for goods, labor and financial transactions.[3]

The stabilization of those hyperinflation episodes illustrates, vividly, the interplay between foreign assistance and domestic fiscal and monetary reform in stopping extreme inflation. In Austria and Hungary, the stabilization was framed within a League of Nations reconstruction plan (also signed by Czechoslovakia) that included two protocols: the first protocol established political and territorial sovereignty of these countries; the second protocol set out a plan for economic stabilization that tied the granting of an international loan to the adoption of fundamental reforms in the fiscal and monetary areas. Two key conditions were incorporated in the loan and actually complied by the countries. First, the institution of independent Central Banks (that replaced the former Austro-Hungarian Bank with its two sections, the Austrian and the Hungarian one). The main proviso in the charters of the newly created Central Banks was the prohibition to discount treasury bills, a practice that, when followed on a massive scale, led to hyperinflation. Second, the budget was to be balanced through a combination of reduced expenditure and increased taxation.

The League of Nations plan also reduced and clarified the amount and timing of the reparation payments owed to the reparations commission; in addition, it lifted the lien on state assets imposed by the original treaty. Those measures were undoubtedly a stabilizing factor, as reduced current and expected fiscal obligations abroad[4]. The result in Austria and Hungary of

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[3] See Dornbusch and Fischer (1986), Solimano (1990a), and Wicker (1986).

[4] The League of Nations loans were not only necessary for the reconstruction of the economies of the receiving countries but also performed the role of enhancing the functioning of the system of international payments emerging after the first world war. In fact, the United States required the allies -- England, France, Italy -- to honor their war debts incurred with the U.S. However, to honor that debts, the allies required the losers of the war -- Germany, the

the plan was a stop of inflation and the stabilization of the currency in 1924 (see Table 3). Poland managed to eliminate hyperinflation and stabilize the currency following similar policies as Austria and Hungary, namely stabilizing the exchange rate, making the Central Bank independent and balancing the budget; however, unlike in the cases of Austria and Hungary, the stabilization was achieved without a League of Nation's loan. Later on, nevertheless, in 1927, when instability in the foreign exchange market started to develop, a large foreign loan was arranged with help of the League of Nations.

Czechoslovakia, formed in 1918, was the only country in Central Europe that managed to avoid a period of extreme inflation in the aftermath of the first world war; as shown in Table 3, Czechoslovakia experienced deflation during 1922-23 (matching that of dollar prices) following the implementation of conservative fiscal and monetary policies. Economic reconstruction went ahead without the detour of passing first for a period of stabilization as its neighbors did.

The second half of the 1920s brought relative prosperity in East-Central Europe. With the consolidation of stabilization, output started to grow until 1929 with the onset of the world depression. Available data on national product for that period shows that Czechoslovakia started to grow since the early 1920s, avoiding the slump occurring in the countries affected by hyperinflation in that period.

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countries formed from the collapse of the Austro-Hungarian empire, Bulgaria --to transfer them resources in the form of war reparations. After a few years it become evident that without external support the loser countries would be unable to meet that obligations. Thus, it is apparent that the League of Nations loans involved just the recycling of war reparations payments.

Table 4: Economic Growth in East-Central Europe in the Interwar Period

National Product*
(annual growth rate, %)

	Czechoslovakia	Hungary	Yugoslavia	Bulgaria
1920 - 1924	4.7	-	3.4	-
1925 - 1929	3.7	5.4	3.7	2.3
1930 - 1933	- 2.9	- 2.4	-2.1	0.0
1934 - 1939	4.5[a]	2.5	4.0	7.5

Source: Elaborated on the basis of B. R. Michell (1975).
* : For Czechoslovakia and Yugoslavia, Gross Domestic Product. For Hungary and Bulgaria, Net National Product.
a: 1934-1937

The recovery of growth in the second half of the 1920s was fueled by two external factors: favorable agricultural prices and foreign capital inflows. Favorable agricultural prices benefitted not only the agrarian countries of the Balkans, but also Hungary and Poland. The major inflow of capital, including direct investment, was coming from the West. England and the United States were the most important sources of foreign capital at the time. Though the economies of East-Central Europe maintained their trade with the rest of Europe and overseas, a general tendency towards protectionism developed in the region in the mid-1920s. In Hungary, average tariffs were raised from 20 percent, the average level prevailing in the monarchy, to 30 percent by 1925. In Rumania import-duties were increased from 30 percent before the war to a level near 40 percent by 1924. Bulgaria raised tariffs levels to prohibitive levels, reaching, in some activities, levels of the order of 100-300 percent higher than before the war.[5]

The exchange rate system ruling in the 1920s in most countries of East-Central Europe followed the "gold exchange standard" system proposed in the

[5] See Berend and Ranki (1974), ch. 9.

Genoa conference of 1922[6]. The system operated on the basis of allowing the Central Banks (reformed with the assistance of the League of Nations as we see before) to hold their reserves partly in the form of foreign exchange -- instead of gold -- against notes in circulation and sight deposits. The U.S. Dollar and the Sterling Pound served as reserve currencies. The system worked relatively well for a while in terms of preventing the deflationary tendencies that a "full" gold standard could have generated given the relative scarcity of gold at that time. Nevertheless, towards the late 1920s, the system came into stress following the events of France in 1928[7]. The response to the loss in confidence in the gold exchange standard in countries like Poland, Czechoslovakia and Bulgaria, was the transfer of their reserves balances from London to Paris as a run against the pound developed Lately, after April 1933, the other reserve currency -- the U.S. dollar -- also ceaced to be eligible for reserves purposes.

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[6] See Nurske (1944) and Kindleberger (1984).

[7] Nurske (1944) describes the situation in the following terms :" The fate of the gold exchange standard was sealed when France decided in 1928 to take nothing but gold in settlement of the enormous surplus accruing to her from the repatriation of capital and from the current balance of payments. The French gold imports certainly aggravated the pressure of deflation in the rest of the world and specially in London. In London the pressure become unbearable in the end, and the gold parity of the Pound was abandoned".

Table 5 Exchange Rates and Prices in the Interwar Period (dollar cents per unit of local currency)

	Czechoslovakia		Hungary		Poland	
	Exchange Rate (crown)	Price Level (1929=100)	Exchange Rate (Pengo)	Price Level (1929=100)	Exchange Rate (Zloty)	Price Level (1929=100)
1925	2.97	109	0.0017[a]	116	17.74	
1926	2.96	103	17.56	102	11.18	91
1927	2.96	106	17.47	109	11.29	103
1928	2.96	106	17.44	112	11.21	104
1929	2.96	100	17.44	100	11.19	100
1930	2.96	89	17.49	87	11.21	89
1931	2.96	81	17.45	82	11.20	78
1932	2.96	74	17.45	82	11.18	68
1933	3.82	72	22.36	71	14.41	61
1934	4.24	74	29.57	71	18.85	58
1935	4.16	77	29.60	78	18.88	55
1936	4.01	77	19.78	80	18.87	56
1937	3.49	82	19.78	86	18.92	62
1938	3.47	81	19.73	87	18.86	58
1939	3.42	93	19.24	86	18.84	57

Source: I. Svennilson (1954). [a]: The Pengo was introduced in 1925.(1pen=12,500 crowns).

Table 5 (cont.) Exchange Rate and Prices in the Interwar Period
(dollar cents per unit of local currency)

	Yugoslavia		Rumania		Bulgaria	
	Exchange Rate (dinar)	Price Level (1929=100)	Exchange Rate (leu)	Price Level (1929=100)	Exchange Rate (lev)	Price Level (1929=100)
1925	1.70	-	0.48		0.73	95
1926	1.76	101	0.46		0.72	87
1927	1.76	104	0.60		0.72	88
1928	1.76	107	0.60		0.72	94
1929	1.76	100	0.60	100	0.72	100
1930	1.76	86	0.60	78	0.72	82
1931	1.76	73	0.60	60	0.72	67
1932	1.64	65	0.60	54	0.72	59
1933	1.76	64	0.78	52	1.00	53
1934	2.27	63	1.00	52	1.29	54
1935	2.28	66	0.93	60	1.30	55
1936	2.29	68	0.74	69	1.30	56
1937	2.30	74	0.73	78	1.29	63
1938	2.31	78	0.73	78	1.24	65
1939	-	79	0.71	88	1.21	66

Source: I. Svennilson (1954).

2.2 The 1930s and After

The economies of East-Central Europe were not immune to the world depression triggered in 1929. These countries suffered the impact of a fall in the world demand for their exports, a deterioration in their terms of trade, and a cut-off of foreign lending.

Agriculture exporting countries like Bulgaria, Rumania and Yugoslavia were heavily affected by the drop in agricultural world prices, particularly in wheat and corn (table 6); a shock that had both adverse income and balance of payments effects. The semi-agrarian, Hungary and Poland also suffered directly from the drop in agricultural world prices and indirectly from the squeeze in industrial demand associated with the decline in real incomes in the agricultural sector. The more industrialized Czechoslovakia (and Austria) experienced a cut in production in industry, in particular in the capital-goods producing sectors during the great depression.

Table 6 Price Index of Grains, East-Central Europe 1930-1933 (1929=100)

	Hungary		Yugoslavia		Rumania		Bulgaria	
	Wheat	Corn	Wheat	Corn	Wheat	Corn	Wheat	Corn
1930	87	59	55	31	63	46	47	51
1931	72	63	57	29	39	34	45	46
1932	77	59	67	29	54	30	34	37
1933	62	32	44	26	63	26	34	25

Source: Berend and Ranki (1974).

National product and the price level fell in the early 1930s, (see Tables 4 and 5) particularly in 1930-33. The financial repercussions of the crisis in real economic activity were compounded by the bankruptcies of German and Austrian banks in 1931. The attempt to keep servicing short-term credits from abroad entailed large losses in the holdings of international reserves and gold of the East-Central European countries. In Hungary major banks were rescued from bankruptcy; in Yugoslavia, total deposits shrunk to a half between 1930-1934 causing the bankruptcies of several financial institutions. In Bulgaria the crisis of the banking system showed up in the failure of the important Banque de Sofia and the merger of several other banks.

In contrast with other countries of the region, Czechoslovakia came through the financial crisis of the early thirties in a much better shape than its neighbors. To a large extent, that was so because the adverse shocks of the early 1930s caught her with a relatively low level of external debt . As Table 7 shows, Czechoslovakia in the 1930s had a level of external debt that was roughly a third of the debt (as a share of national income) of the other countries in East-Central Europe. That made Czechoslovakia less vulnerable to increases in the foreign interest rate and/or a cut-off of foreign lending.

Table 7 Indicators of Foreign Debt in East-Central Europe in 1930 (dollars)

	Hungary	Czechoslovakia	Yugoslavia	Rumania
Foreign debt per capita	65.0	34.0	66.0	75.0
National income per capita	116.0	171.0	93.0	107.0
Foreign debt as a share of national income	56%	19.9%	70.1%	70.1%

Source: Berend and Ranki (1974).

The policy response to the depression of the 1930s in the countries under study included the imposition of foreign exchange controls along with limited currency convertibility; in addition, foreign trade started to be conducted under a system of administrative controls and approvals. That changed, quite dramatically, the relative freedom of trade the 1920s (though, as noted before, tariffs were far from low in that period) and reduced the degree of capital mobility, the economies of East-Central Europe enjoyed under the gold exchange standard system.

Following the example of Germany, the economies of East-Central Europe abstained initially from devaluation, when facing the adverse external shocks of the early 1930s. To counteract a loss of external competitiveness in most of these countries a "bonus system" came in operation. The bonus consisted in a combination of a subsidy to exporters with a tax to imports aimed to increase the relative price of traded goods (with respect to home goods) by means different of the nominal devaluation[8]. Moreover, in 1933, additional imports duties were raised in Czechoslovakia, Hungary and Poland. That tariffs barriers were held during the thirties and intensified in second world war when additional import controls were imposed.

The payment of external debt, both amortization and interest servicing was suspended in Hungary between 1931-1933. Partial suspension of foreign debt servicing took also place in Rumania, Yugoslavia and Bulgaria even after the worst of the world depression had passed. In contrast, Czechoslovakia did not need to resort to the suspension of its foreign debt obligations. The case of Poland was somewhat special in this respect. The government did not adopt restrictive policies during the years of the depression and tried to maintain the gold standard parity of the zloty and paid amortization when due; however, the policy was unsustainable and, in 1936, the government had to reschedule its payments obligations abroad and foreign exchange controls were imposed.

An important external factor that shaped the developments in East-Central Europe in the second half of the thirties was the establishment of a "war economy" in times of peace in Nazi-Germany in 1933. That system aimed to accelerate growth and required to secure agricultural products and raw materials to support Germany's rearmament. This was initially welcomed by the

[8] The bonus system was administratively cumbersome as the size of the subsidy-tax varied across currency and trade partner.

countries of Central Europe and the Balkans for they were suffering from a depressed world demand for their products. Moreover German trade policies after 1933 were conducted on a bilateral basis priorizing direct exchange of goods -- barter trade -- rather than the use of international means of payments, scarce in Germany and in other countries of the region.

Table 8 Composition of Trade with Germany of East-Central European Countries in the 1930s

	Exports to Germany as Percentage of total		Imports from Germany as Percentage of Total	
	1929	1937	1929	1937
Hungary	11.7	24.1	20.0	26.2
Yugoslavia	8.5	21.7	15.6	32.4
Rumania	27.6	19.2	24.1	28.9
Bulgaria	29.9	43.1	22.2	54.8

Source: Berend and Ranki (1974)

Table 8 shows that several countries of East and Central Europe increased substantially the share of their trade conducted with Germany toward the second half of the 1930s. That trend was particularly noteworthy in Hungary, Yugoslavia and Bulgaria.

Let us turn now to the level of national income per head, the structure of economic activity and foreign trade toward the late 1930s in the region. Table 9 neatly portrays the relative backwardness of the countries of Eastern Europe with respect to Western Europe in the 1930s. Austria and Czechoslovakia were the countries with the highest per capita income in Central Europe, though their (average) income per head was around 40 percent of the per capita income of Great Britain (the most developed nation in Western Europe at that time). In turn, the national per capita income of Great Britain was near six times the national income per capita of Bulgaria the poorest country in Eastern Europe. Moreover, the average income per capita of East-Central Europe was around one-third of the level of income per-capita of Western Europe.

Table 9 National Income Per Capita in Europe, 1937 (dollars)

Western Europe	
Great Britain	440
Sweden	400
Germany	340
Belgium	330
Holland	306
France	265
East-Central Europe	
Austria	190
Czechoslovakia	170
Hungary	120
Poland	100
Rumania	81
Yugoslavia	80
Bulgaria	75

Source: Economic Survey of Europe, 1948. Geneva, 1949.

With the exception of Czechoslovakia and Austria, most of the countries of East-Central Europe had a predominantly agrarian economic structure by the late 1930s. In the Balkan countries (on average), nearly 55 percent of national income was generated in agriculture (63.3% in Bulgaria). In Hungary and Poland the share of national income generated in agriculture was around 37 percent, on average, in 1937. Agriculture was relatively backward in these countries, showing low productivity growth, a structure of land tenure where tiny plots owned by the peasant coexisted with large unexploited farms owned by relatively wealthy landlords; in addition surplus labor was another feature of the low level of agricultural development in the area.

The share of manufacturing in income was 53 percent in Czechoslovakia, near 34 percent in Hungary and Poland, and around 23 percent in Yugoslavia, Rumania and Bulgaria. In Czechoslovakia, the industrial sector concentrated in the capital-goods producing sector, chemicals and other "heavy" branches. In contrast, in the less industrialized countries of the region the manufacturing sector focused in the processing of food, textiles and other "light" activities.

Table 10 Structure of National Income by Economic Sectors of Selected East-Central European Countries, 1938
(percentages)

	Agriculture	Industry	Construction and Services	Total
Czechoslovakia	23.2	53.2	23.6	100.0
Hungary	36.5	35.7	27.8	100.0
Poland	39.0	32.2	28.8	100.0
Rumania	53.2	28.4	18.4	100.0
Yugoslavia	53.6	22.1	24.3	100.0
Bulgaria	63.3	18.3	18.4	100.0

Source: Berend and Ranki (1974)

Their structure of foreign trade reflected their pattern of development and specialization. In most of these countries the bulk of their exports were composed by raw materials and food, whereas their imports concentrated, mainly, in manufacturing goods and intermediate inputs. In contrast, Czechoslovakia was a net exporter of manufacturing goods and a net importer of raw materials and food.

Table 11 Structure of Foreign Trade in East-Central Europe, 1938
(percentages)

Exports

	Czechoslovakia	Hungary	Poland	Yugoslavia	Rumania	Bulgaria
Manufactured goods	71.8	13.0	6.4	0.8	1.9	2.0
Raw materials and intermediate goods	19.8	31.7	65.1	49.5	64.3	66.6
Foodstuffs	8.4	55.3	28.5	49.7	33.8	31.4
	100.0	100.0	100.0	100.0	100.0	100.0

Imports

	Czechoslovakia	Hungary	Poland	Yugoslavia	Rumania	Bulgaria
Manufactured goods	29.6	30.2	28.4	44.8	68.3	68.0
Raw materials and intermediate goods	57.5	61.5	54.1	50.1	27.3	31.5
Foodstuffs	12.9	8.3	17.5	5.1	4.5	0.5
	100.0	100.0	100.0	100.0	100.0	100.0

Source: N. Spulber (1957).

As we mentioned before the economy (and the politics) of East-Central Europe was directly affected by the German drive toward the war. Here a distinction should be made among the group of countries that were (at least) partly annexed in 1938-39, namely Czechoslovakia and Austria or the so-called "Czech-Moravian Protectorate", the "satellites" countries: Hungary, Rumania and Bulgaria and the group of countries that were occupied and physically devastated: Poland and Yugoslavia. The members of the "Czech-Moravian Protectorate", given its relatively advanced stage of industrialization and financial development were integrated into the German economy under a system of centralized state control, typical of a war economy. Moreover, the intervention of the "protectorate" entailed some confiscation of property including industry and bank assets.

In Hungary, Rumania and Bulgaria, the war economy did not involve open occupation though German control was effective. These countries supplied food, agricultural products in general and raw materials like iron, bauxite, and timber to Germany. The intervention had also some important macroeconomic consequences as Germany accumulated debts with these countries for unpaid supplies. To compensate domestic producers for those unpaid orders the national governments started to print bank notes. Thus, following unpaid German deliveries, a "money overhang" developed. In turn the inflationary impact of excessive liquidity was repressed by rationing of goods. On the supply side a system of compulsory deliveries of fix quotas of agricultural goods and raw materials to the state was enacted and severely enforced.

The third group comprised by Poland and Yugoslavia was the hardest hit during the war. Both countries lost their national independence and their territories were split and occupied by Germany, Italy, and the Soviet Union. In addition parts of Yugoslavia were annexed to Hungary and Bulgaria. The initial strategy of the axis-countries against Poland and Yugoslavia was outright destruction entailing annihilation of communication, and destruction of physical infrastructure and industrial capacities. However, that policy was shifted afterwards and priority was given to secure deliveries of food and raw materials to Germany as its involvement in the war required enhanced supply of those goods. By the end of world war II most of the countries of East-Central Europe suffered enormous losses. Poland and Yugoslavia lost an important part of their population, their railway system was severely damaged as well as roads and infrastructure and communications in general. In addition the capital stock in industry and agriculture was partly destroyed with the obvious adverse effect on productive capacities.[9]

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[9] The estimates of the destructions are imprecise though some numbers exist: Yugoslavia lost 10 per cent of her population and half of the industrial engines and around 40 to 50 percent of agricultural machines and equipment were destroyed. In Poland, 40 per cent of railways were destroyed, 85 percent of housing in Warsaw were devastated besides huge destruction in industry and agriculture. See Berend and Ranki (1974), ch. 13.

2.3 The Establishment of Socialism in the Second Half of the 1940s

The end of second world war brought far-reaching political and economic changes to East-Central Europe. A redistribution of territories in Poland, Czechoslovakia, Rumania and Bulgaria took place[10]. The Soviet Union gained territories at the expense of these countries and Poland was retributed with territories of Germany. As it could be expected, all these changes altered the resource availability in terms of agricultural land, natural resources and industrial capital stock in the area. The major changes took place in Poland and Czechoslovakia as the changes in their national boundaries were of a more sweeping nature. In addition the Soviet Union required in the peace treaties the deposition of German assets in the former satellites countries of Germany (Hungary, Rumania, and Bulgaria). At the political level, the governments emerging after the second world war were formed by broad political coalitions running from liberals to communists. The dynamics of the political situation was such that the communist parties managed to acquire, in various cases through coup d'etat, dominant positions in government and the state after 1948. Following the new political setting, the economies of Eastern Europe were reorganized along the lines of the Soviet economic system. The first and most important move was the nationalization of industry, the financial system, the trade and services sectors along with a process of agrarian reform, the latter being an old aspiration of the political left and the peasantry.

In Czechoslovakia, before the communist coup d'etat of February of 1948 the nationalization laws brought into the state sector near 57 percent of total industrial labor force. After 1948 that process accelerated and by 1949 just 3 percent of total employment in manufacturing was generated in the private sector. In Poland the state sector accounted for near 85 percent of total employment in the manufacturing sector for units with over 5 workers in 1946; moreover, the tendency to full nationalization of industry was almost complete by the early 1950s. In Hungary, after a relatively moderate start in

[10] Hungary was the only country that returned to its pre-war territorial status (see Spulber 1954).

terms of nationalization, the process was intensified since 1948 with the deepening of nationalization of medium and large scale firms in manufacturing. With some specific differences the same process also took place in Rumania and Bulgaria.

By 1949 the share of the socialized sector in gross manufacturing output ranged from 85 percent in Rumania to 92 percent in Hungary, 93 percent in Bulgaria, 94 percent in Czechoslovakia and 100 percent in Yugoslavia.[11] Thus, the private sector practically disappeared from the productive sphere in a period of around five years.

The nationalization laws contemplated the compensation of former owners of the enterprises[12] through treasury bills, money payments or paper issued by newly created funds. The extent of compensations actually carried-out is hard to determine, though there is a widespread presumption that they were ultimately very low. Besides, the nationalization process spurred the merging and consolidation of nationalized enterprises thereby creating monopolistic market structures. Moreover a few units ended-up producing the total supply of given goods. Also nationalization encouraged vertical integration and required centralized decision making. Therefore central planning and full state-ownership become closely intertwined.

The nationalization of the banking and financial systems was facilitated in Czechoslovakia, Poland, and Yugoslavia because there was no private property of major financial institutions after the war. In general a process of merging and centralization in "State National Banks" took place in Poland, Hungary, Rumania, Yugoslavia and Bulgaria in the late 1940s. Those State National Banks performed several roles: they had the monopoly of issuing money, and therefore acted as Central Banks, they regulated the financial system, and provided short-term credits to enterprises in the context of the

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[11] See Spulber (1957), pp.83.

[12] The exception was the property confiscated to ex-collaborators. The compensation, when occurred, to foreigners were in general made on a ad-hoc basis and tied to trade negotiations and other deals.

planning system. In turn, Savings and Investment Banks (very often just branches of the State National Bank), received savings from the population and channeled them as financing for investment.

The monetary history of the region after World War II resembled in several ways that of the post world war I period. After world war II the financing of the war by printing money (along with rationing) left a money overhang. Moreover after 1945, the effort of reconstruction and the need to recapitalize and expand the nationalized sector led to a rapid expansion of money supply in several East-Central European economies (see Table 12).

Table 12 Currency in Circulation in Czechoslovakia, Poland and Yugoslavia, 1945-1947

	Czechoslovakia	Poland	Yugoslavia
1938	100	100	100
1945	254	1,878	231
1948	908	12,400	509

Source: Spulber (1957)

From another angle the accumulation of excessive liquidity originated from an excessive increase in the wage bill relative to the output of consumer goods at fixed prices ("too high wages" chasing for "too few goods"). The resulting shortages in the consumption goods market led to an accumulation of involuntary savings in the form of liquid assets.

Table 13 Consumption Spending and Wages, 1948-1951

	1948	1949	1950	1951
Czechoslovakia				
Consumption	100	108	118	131
Wage Bill	100	112	142	159
Hungary				
Consumption	100	122	134	152
Wage Bill	100	131	169	206
Poland				
Consumption	100	101	118	126
Wage Bill	100	143	180	256
Rumania				
Consumption	100	90	109	111
Wage Bill	100	154	210	N.A

Source: Ames, E. (1954).

As the accumulation of excessive liquidity threatened to become an inflationary factor, governments implemented monetary reforms to soak-up lavish monetary balances. The monetary reforms comprised at least one of the following measures: (1) the reduction in the supply of liquid assets through the compulsory exchange of "old" money into "new" money at a given rate of conversion; (2) the immobilization of a fraction of the supply of liquid assets in the form of blocked deposits in the banking system. The blocked funds were put in special accounts and individuals were able to spend just on the unblocked part of their deposits, (though they were still owners of the full deposits); (3) the conversion of wages to a new unit, at a given rate of exchange.

In several countries of the region, the monetary reforms involved differentiated rates of conversions for bank notes vis-a-vis bank deposits, with a more favorable rate of conversion for deposits (this intended to tax speculators who often operated with currency). In addition, a distinction was made according to the amount of liquid assets held by individuals and enterprises, favoring small holders against large ones or private enterprises.[13]

The actual rates of conversions of money varied from country to country: in the Hungarian monetary reform of December 1945 the rate of conversion was 4 to 1 for bank notes. In Bulgaria, the rate of conversion was 100 to 1 in the reform of March, 1947. In Rumania, the rates of conversion varied from 100 to 1, to 400 to 1 in the monetary reform of January 1952. Blocking of bank deposits took place in Poland in December 1944, in Czechoslovakia in October 1945, in Bulgaria in March 1947.[14]

The extent to which monetary reforms were successful in reducing excess liquidity and inflationary pressures in Eastern Europe may be debatable as, in general, the rate of conversion for wages were more favorable than for money[15]. Moreover, the task of reducing excess liquidity was not an easy one as several countries of the region had to implement more than one monetary reform in the period 1945-53.

A (classic) case of hyperinflation in the transition to socialism is provided by Hungary in 1945-1946. Moreover, this was the second Hungarian hyperinflation after the one of the early 1920s. This second hyperinflation of 1945-1946 was more intense than the former one in Hungary and was more extreme than the German hyperinflation of 1923. As in other historical episodes of extreme inflation, the Hungarian one of 1945-1946 came associated with a severe increase of the fiscal deficit. As Table 14 shows, during most of the hyperinflation, tax revenues financed less than 10 percent of fiscal expenditures. An important element in the deterioration of fiscal finances was the burden imposed by the reparations payments agreed by Hungary in the

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[13] See Gurley (1953) for an interesting discussion and documentation of monetary reforms in Western and Eastern Europe. A more recent analysis of the topic is Dornbusch and Wolf (1990).

[14] Blocking of bank deposits also were part of the monetary reforms in Western Europe after World War II. Examples are Belgium in October 1944, France, June 1945, and January 1948; Austria, Denmark, Norway and Netherlands in 1945; see Gurley (1953).

[15] See Ames (1954).

armistice of January 1945. That reparations were to be paid mainly to the Soviet Union, and also to Czechoslovakia and Yugoslavia[16]. Reparations and occupation costs represented between 25-50 percent of public spending[17]. The financing of the fiscal deficit was done through treasury bills issued by the Hungarian government and discounted by the Central Bank. In addition, one of the features that is considered as crucial in the making of an astronomical inflation in Hungary was the indexation of the money supply.

Table 14 Public Finances in Hungary, 1945-1946

	Percentage of fiscal expenditures financed by fiscal revenues	Occupation and reparation costs as percentage of fiscal expenditure
1945		
July	6.8	23.0
August	5.3	34.0
September	7.3	23.0
October	5.7	24.0
November	6.6	31.0
December	7.1	40.0
1946		
January	14.2	26.0
February	14.4	32.0
March	13.0	39.0
April	9.8	50.0
May	7.3	38.0

Source: Bomberger and Makinen (1983).

[16] The reparation payments were calculated in US$ 300 million and they had to be paid in a period of 6 years. The national income of Hungary in 1945-1946 is estimated in around 1 billion dollars; see Bomberger and Makinen (1983).

[17] The worsening of the fiscal situation in Hungary also came from the side of reduced tax revenues due to the administrative mismanagement after the war, the destruction of records on income and assets during the war, the fall in the level of economic activity and the acceleration in inflation, see Bomberger and Makinen (1983).

Table 15 Inflation in Hungary, 1945-46
(price level, January 1945=100)

1945		
	I	104
	II	124
	III	290
	IV	1,826
1946		
	I	4,442
	II	185×10^6

Source: Spulber (1957)

The Hungarian stabilization plan of August 1, 1946 -- designed by the marxist economist Eugene Varga and backed by the communist party -- consisted of the following measures: (1) Monetary reform. A new unit was introduced, the forint and, initially, a 100 percent reserve requirement was imposed on commercial banks. The central bank was forbidden, by law, to make direct or indirect loans to the government. The practice of discounting treasury bills was abolished, and the only operations allowed between the treasury and the central bank were loans to finance the acquisition of gold or foreign currencies; (2) Fiscal Reform. The tax system was completely revamped, raising the tax rates on labor income and property as well as the sales tax. A turnover tax on enterprises was introduced and fiscal expenditures were reduced by cutting the number of civil servants and reducing the size of the army and police; (3) External financing. The plan had external support in the form of tied U.S. loans, increased food supplies granted by the U.N. and an extended payment period to the Soviet Union over that initially agreed in the armistice of 1945.

The plan succeeded and hyperinflation rapidly stopped. From August 1st to December 1946, inflation rose by 6 percent. The rate of inflation in 1947 was approximately 19 percent. Stabilization came along with rapid monetization (the increase in money demand following the stabilization was accommodated) and the money stock increased by 221 percent between August 31, 1946 and December 31, 1946. During 1947, the nominal money stock grew by 132 percent.[18]

The effects of stabilization on output and employment are hard to determine given the sketchy data available though a reduction in employment along with an increase in national product seemed to have taken place during 1946-1947. The aftermath of the stabilization was dominated in the political stage by the communist coup d'etat of June of 1947 forcing the resignation of prime minister Nagy. As a result of the coup, the communist party took over practically all of the ministries in the government and the state was reorganized in a way instrumental to the establishment of socialism. On the economic sphere, the nationalization process and the imposition of central planning was definitely accelerated.

3. The Collapse of Socialism in East-Central Europe: the Late 1980s

The seemingly irreversible socialist experiment in East-Central Europe came to sudden, and largely unexpected, end towards the late 1980s. The collapse of Soviet-style socialism has both economic and political roots. Central planning led to endemic shortages, slow technical change, low-quality goods and overexpanded public sectors. In practice, full employment and social protection was bought at the price of economic backwardness and lack of political freedom. Attempts of partial reform in the 1980s often worsened macroeconomic conditions as credit and wage policies were relaxed and fiscal budgets turned into deficits. In addition, several Eastern European economies borrowed heavily abroad accumulating large external debt that further complicated domestic economic management.

At the political level, more than four decades of one-party rule and authoritarianism generated (non-official) domestic consensus on the need for political opening and democracy. In 1989, the authoritarian regimes dominated by the communist party (or its equivalent) were toppled by emerging political

[18] See Bomberger and Makinen (1983).

parties and social movements with an agenda of political transition to a western-style democracy and the creation of a market economy.

Let us present some data to have a broad picture of both the final state of the socialist experiment and the initial conditions in the transition towards the market economy.

Table 16 Inflation and GDP growth in selected East-Central European Countries, 1986-1990 (percentages)

	Poland		Yugoslavia		Hungary		Czechoslovakia		Bulgaria	
	GDP growth	Infl. rate*	GDP growth	Infl. rate	GDP growth	Infl. rate	NMP** growth	Infl. rate	GDP growth	Infl. rate
1986	1.5	18.0	3.4	89.8	1.5	5.3	2.6	0.50	4.2	1.3
1987	3.4	25.2	-0.5	120.8	3.4	8.6	2.1	0.09	6.1	0.07
1988	0.1	60.0	-1.0	194.1	0.1	15.7	2.3	0.09	2.6	2.3
1989	-1.0	700.0	-2.0	2,700.0	0.5	1 9.6	1.9	1.44	-1.9	4.4
1990	-10.0	58.0[a]	-5.0	70.5[b]	-2.2				-10.0	

Source: The World Bank.
*: The inflation rate for every country corresponds to the Consumer Price Index. **:Net Material Product. [a]:January-August,1990. [b]: January-October, 1990.

The image emerging from Table 16 is that of deteriorated economic conditions and is reflected (among other indicators) in lower growth and higher inflation in the second half of the 1980s. Macro instability was more acute in Yugoslavia and Poland where (near) hyperinflation developed in 1989. To eradicate (high) inflation and create a more favorable macro environment for a market-oriented economy, both countries adopted sharp anti-inflationary policies in early 1990. Those plans included a large real depreciation of the exchange rate, the deregulation of most of controlled prices, a tight monetary and credit policies, the correction of fiscal deficits and a drastic lowering in imports tariffs[19]. In addition, an initial attempt of privatization of state-owned enterprises is being carried-out in both countries with still limited success.

Hungary and Czechoslovakia are in better shape, though current inflation in Hungary is considered relatively high. Czechoslovakia, following a long history of macro stability and prudence (that comes back from its pre-socialist period) has not experienced any open inflationary upsurge until now, though some acceleration in inflation can not be discarded for the future. Economic decline in Bulgaria is quite dramatic: output growth was negative in 1989 and an additional drop in GDP by near 10% in 1990 is expected. Any recovery in real economic activity will be slow as the country -- heavily dependent in its foreign trade with the U.S.S.R. -- is expecting a large deterioration in its terms of trade associated with the collapse of Comecon. Inflation is also a potentially serious problem there as the fiscal deficit deteriorated and a large money overhang accumulated in the previous years.[20] The economic outlook for Eastern Europe is bleak. Negative growth in 1990 is a sheer witness of the collapse of the ancient economic system. The current situation does not leave much room for optimism given the monumental task of transforming a very obsolete economic system into a dynamic one. Currently, the problems of structural transformation are compounded by the disintegration of Comecon (it will entail a big terms of trade deterioration for Eastern Europe vis a vis the Soviet Union), and the reluctance of international capital markets to commit ample credit to the region until the process of reform gets more consolidated.

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[19] For a description of the stabilization policies in Poland, see Lipton and Sachs (1990a). A comparative analysis of the Polish and Yugoslav stabilization plans is Coricelli and Rocha (1990). For an analysis of privatization in Eastern Europe see Lipton and Sachs (1990b).

[20] See Solimano (1990c) for an analysis of the Bulgarian case.

Table 17 **Structure of GDP in selected East-Central European Countries, 1988[a]** (percentages)

	Agriculture	Industry	Construction and Services	Total
Czechoslovakia	6.4	59.6	34.0	100.0
Hungary	14.0	37.0	49.0	100.0
Poland				
Yugoslavia	14.0	49.0	37.0	100.0
Bulgaria[b]	12.6	58.5	28.9	100.0

Source: The World Bank.
[a]: the shares for Czechoslovakia and Bulgaria correspond to NMP.[b]: the shares correspond to 1989.

Looking at the structure of production in East-Central Europe in the late 1980s it is noticeable the reduced share of agriculture in output and the relatively high share of industry in output (between 50 to 60 percent).[21] Socialist industrialization significantly altered the production structure of the 1930s (table 10). While Bulgaria, Yugoslavia and Rumania were predominantly agrarian economies with a share of agriculture on national income of over 55 percent in 1938, in the late 1980s that share got reduced to less than 15 percent. However, as we shall see below, socialist industrialization did not bring much prosperity; for illustration purposes take the case of Spain, a backward Western European country in the thirties, that industrialized in the 1950s and 1960s around (protected) market lines, ended up with a level of per capita GDP (1988) of around three times higher than the average GDP per capita of East-Central Europe in the same year (see Table 19). Socialist industrialization had an initial "easy phase" as it pulled idle resources from the agricultural sector; however it turned very capital intensive and focused heavily in the development of the capital goods

[21] This number tends to be a bit overstated in Czechoslovakia where the ratio is with respect to Net Material Product (that excludes several services like education, health and other "non-productive" activities).

sector in clear detriment of the production of manufacturing consumer goods whose quality was poor[22]. In practice the industrialization process in Eastern Europe came along with a wall of tariffs and prohibitions of imports from the West. The pattern of specialization was dictated by the needs of the Soviet Union and the location of production did not follow comparative advantages criteria.

Table 18 Size of the State Sector in East-Central Europe (percentage of output and employment generated in the public sector)

	Output	Employment
Czechoslovakia (1986)	97.0	
East Germany (1982)	96.5	94.2
Poland (1985)	81.7	71.5
Hungary (1984)	65.2	69.9

The end of the centrally planned economy in East-Central Europe leaves as a legacy an almost complete dominance of the public sector in the generation of output. A year of transition from socialism suggests that privatization is crucial for creating a market economy, though that process is bound to face multiple obstacles both of an operational as well as political nature.

Finally, a look at recent levels of per capita GDP in several countries of East-Central European countries is revealing. Using World Bank estimates of per capita GDP in dollars for 1988, (Table 19) it is clear that the historical differences between Eastern and Western Europe existing in the late thirties (Table 9) did not narrowed down after 40 years of socialism. Quite

[22] See Solimano (1990b) for a discussion of the patterns of productivity growth in socialist economies.

on the opposite, the data suggests (of course with the usual caveats involved in comparisons of real income over time and across countries) that differences in per capita income have widened spectacularly. For example while in 1937 Czechoslovakia had a national income per head just 10 percent below of that of Austria, in 1988 the GDP per capita of Czechoslovakia was near one-fifth of the GDP per head of Austria (U$ 3,300 for Czechoslovakia versus U$ 15,470 of Austria). In 1988 the GDP per capita of one of the most developed countries in Western Europe (measured by GDP per capita), say West Germany was 5.6 times larger than the GDP of Czechoslovakia (the most developed country of East-Central Europe). In contrast, in 1937, the national income per head of Great Britain was just 2.6 times the income per head of Czechoslovakia.[23] Currently the average GDP per capita of East-Central European countries are closer to the levels of output-per capita of Latin American countries like Mexico, Brazil and Argentina.

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[23] Great Britain was the country with the highest per capita income in Europe in the 1930s.

Table 19 GDP per Capita in Selected East-Central European Economies
(in dollars of 1988)

Poland	1,860
Hungary	2,460
Yugoslavia	2,520
Czechoslovakia	3,300

Mexico	1,760
Brazil	2,160
Argentina	2,520

Spain	7,740
United Kingdom	12,310
Italy	13,330
Austria	15,470
France	16,090
Germany, R.F.	18,480
United States	19,840

Source: World Development Report, 1990. The World Bank.

4. Concluding Remarks and Summary

This paper reviews first the main features of the economic history of East-Central Europe in the interwar period, and the forties included the establishment of socialism. Then it looks at the initial conditions for the transition to a market economy after the collapse of socialism in the late 1980s. A summary of our main findings follows:

● The economic history of East-Central Europe shows episodes of extreme inflation and exacerbated macroeconomic instability after World War I and the early 1920s. Examples of that were the hyperinflation of Poland, Hungary, Austria. Stabilization of hyperinflation in Poland, Hungary and other Central

European economies required stabilizing the exchange rate, fiscal reform, the inception of independent Central Banks and (conditional) foreign financing provided by the League of Nations. The case of Czechoslovakia, formed with part of the territories left from the Austro-Hungarian empire stands by its own as it managed to sort out the reconstruction period after World War I without inflation and with macroeconomic stability.

● The second half of the 1920s in East-Central Europe was a period of relatively high growth, low inflation, moderate protectionism and increasing financial integration in the context of the gold exchange standard system. London and New York were the main financial centers at the time and the British Pound and the US dollar the reserve currencies besides gold.

● The great depression of 1929-1933 hit particularly hard Bulgaria, Rumania and Yugoslavia. The drop in the international price of agricultural products was a adverse foreign shock for these agrarian economies. Moreover, the disruption in the flows of foreign financing also hit the Balkans, Hungary Poland and the most industrialized Czechoslovakia. The response of the countries of East-Central Europe to the adverse external shocks and the collapse of the gold exchange standard in the early 1930s included the imposition of foreign exchange controls, the rise in import duties and the suspension of debt payments abroad.

● The initial recovery of most economies in East-Central Europe in the second half of the 1930s was driven basically by Germany. The preparation for war in that country required an abundant supply of agricultural products and raw materials that could be provided by the Balkans countries, and also by Hungary and Poland. The large industrial base of Czechoslovakia was also instrumental for the German rearmament. To enhance foreign control, this country and Austria (the "Czech-Moravian Protectorate") were finally annexed by Germany before the war.

● Poland and Yugoslavia were the countries that suffered more in terms of destruction of productive capabilities, destruction of infrastructure and housing and human losses with the occupation and second world war.

Czechoslovakia was the country that suffered comparatively less after the conflict.

● After 1945 the nationalization of industrial firms, the financial system and the launching of agrarian reform were the main features of the economic policies implemented by the coalition governments that emerged in East-Central Europe after the war. Besides, the drive toward full nationalization and the creation of a system of central planning fully consolidated after a series of coup d'etat led by the communist parties in 1948.

● The second half of the 1940s provides an interesting laboratory of monetary reform aimed to reduce excess liquidity accumulated during the war and thereafter. The reforms involved the reduction of the money supply through (differential) rates of exchange between "old" and "new" money in Hungary, Rumania, Poland and Bulgaria. The blocking of deposits in the banking system took place in Poland, Czechoslovakia, and Bulgaria between 1945-1955. Some of these reforms were implemented also in Western European countries like France, Austria, Belgium and others over the same period.

● A neat case of hyperinflation in the transition to socialism was Hungary in 1945-1946. Economic stabilization in Hungary was achieved when public finances were brought in balance, the currency stabilized and a package of foreign financing and debt and war reparations relief was put in place.

● The collapse of socialism in East-Central Europe in the late 1980s made evident the structural weakness of central planning in improving the standards of living of the population. Economic hardship and closed political systems could not last forever. Systemic reform has come along with increased macroeconomic stability in several cases. Hyperinflation was rampant in Poland and Yugoslavia in 1989. In addition, public finances and the balance of payments deteriorated in most countries of the region. Economic transformation looms as a long and complicated process as the initial conditions for the transition to a market economy are very weak. In fact, these economies are characterized by obsolete and uncompetitive productive capacities, macroeconomic imbalances, lack of modern infrastructure and factor markets and weak institutions besides other factors. In addition, the external environment in the east is not very supportive: the disintegration of the Comecon will entail large terms of trade losses for Eastern Europe vis a vis the Soviet Union and a massive influx of western capital is unlikely to be observed in the short to medium run. On the political side, the initial euphoria associated with the end of the old regime is being replaced by a less enthusiastic public attitude towards the hardships of the transition. Fragile and changing political coalitions and the temptation of populism clearly reflect that tendencies.

● Finally, an important finding of the paper is that the differences in per-capita income between Eastern and Western Europe have widened after socialism. In 1937, before second-world war and socialism, the ratio of income per head of the highest income per capita in Western Europe at the time (Great Britain) to the highest income per head in East-Central Europe (Czechoslovakia) was <u>2.6</u> times. In 1988, the ratio of per capita income of West Germany (now with higher per capita income than Great Britain) over the GDP per head of Czechoslovakia is <u>5.6</u> times. The average income per capita of Eastern Europe is nowadays closer to the level of per capita income of Latin American countries like Mexico, Brazil and Argentina.

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